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Henry Ordower
Saint Louis University - School of Law

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Henry Ordower
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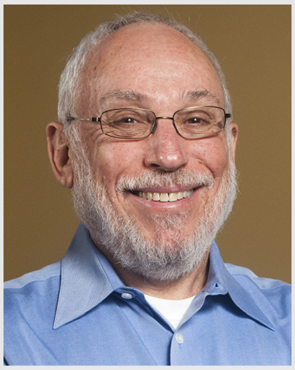

Henry Ordower

Henry Ordower is a professor of law at Saint Louis University School of Law in St. Louis.

In this article, Ordower examines instances in which the Supreme Court reviewed state tax laws for conflict with the Constitution and overruled its earlier decisions in similar cases. He also looks at a single long-standing Supreme Court precedent limiting federal income taxation under the Constitution and at avoidance of state constitutional taxing limitations.

The U.S. Constitution reserves all powers to the states or the people unless that power is delegated expressly to the United States or prohibited expressly to the states.[1] The Constitution delegates the power to impose taxes to Congress: "The Congress shall have power to lay and collect taxes, duties, imposts and excises; but all duties, imposts and excises shall be uniform throughout the United States."[2] In addition to uniformity, the Constitution requires that "direct taxes . . . be apportioned among the several states which may be included within this union, according to their respective numbers,"[3] and that "no capitation, or other direct, tax shall be laid, unless in proportion to the census or enumeration."[4]

The 16th Amendment, which was adopted in 1913,[5] permitted an income tax without apportionment among the states. The amendment was necessary for the enactment of a federal income tax because the Supreme Court in *Pollock v. Farmers' Loan & Trust Company*[6] invalidated an 1894 income tax as a direct tax on capital requiring apportionment.[7]

While the Constitution prohibits federal duties on exports but not imports,[8] it gives Congress exclusive jurisdiction over duties by prohibiting states from imposing import or export duties unless Congress consents.[9] In other areas, the Constitution does not limit the states' power to impose other taxes despite taxing power having been delegated to the United States.

All 50 states have their own constitutions confirming the state and local power to tax, but taxpayer initiatives in some states have added express constitutional limitations on taxation,[10] for example, the Hancock Amendment in Missouri[11]

[1] U.S. Const. Amend. X (1789): "The powers not delegated to the United States by the Constitution, nor prohibited by it to the States, are reserved to the States respectively, or to the people."

[2] U.S. Const. Art. I, section 8, cl. 1.

[3] U.S. Const. Art. I, section 2, cl. 3.

[4] U.S. Const. Art. I, section 9, cl. 4.

[5] U.S. Const. Amend. XVI (1913).

[6] 157 U.S. 429 (1895), *affirmed on rehearing*, 158 U.S. 601 (1895).

[7] U.S. Const. Art. I, section 2, cl. 3.

[8] U.S. Const. Art. I, section 9, cl. 5.

[9] U.S. Const. Art. I, section 10, cl. 2, 3.

[10] Ariel Jurow Kleiman, "Tax Limits and the Future of Local Democracy," 133 *Harv. L. Rev.* 1884 (2020) (cataloguing and analyzing state tax limitations).

[11] Mo. Const. Art. X, section 16 et seq.

and Proposition 13 in California.[12] The Hancock Amendment restricts the power of the Missouri legislature and local jurisdictions to increase existing taxes by more than an inflation adjustment or to enact any new tax without approval of the electorate by ballot referendum.[13] Proposition 13 limited increases in state ad valorem property taxes on personal residences (a principal source of local revenue supporting schools and other government services) until the property is sold in an arm's-length transaction. Then the tax could increase to an amount based on the transfer price rather than the previous owner's historical cost.

The first part of this article provides background of constitutional review of federal and state laws and compares review in other countries. The second part examines instances in which the Supreme Court reviewed state taxing laws for conflict with the Constitution and overruled its earlier decisions in similar cases. One case involving a poll or capitation tax worked its way through the courts as the Constitution was being amended to prevent the states from using a poll tax. Another case, from 2018, resolved a long-standing tax collection and avoidance problem with state sales taxes. The third part focuses on a single long-standing Supreme Court precedent limiting federal tax law under the Constitution, which Congress increasingly has not followed. The decision and recent congressional action is contextual in the current discussions of other tax proposals. The fourth part considers areas in which constitutional limitations exist, but legislatures and courts seem to have no interest in addressing them. The fourth part is the conclusion.

Constitutional Review of Taxes

In *McCulloch v. Maryland*,[14] the U.S. Supreme Court[15] held that a state tax on a national bank impermissibly interfered with the federal government's lawful exercise of its powers, including powers "necessary and proper" to the United States, even though the powers were not expressly enumerated in the Constitution.[16] *McCulloch* accepts the concurrent power of both states and the federal government to tax, but its limitation of the state's power to tax federal functions and, conversely, the federal government's power to tax states, is based in the notion "that the power to tax involves the power to destroy."[17] This decision led to development of a doctrine of intergovernmental tax immunity. The scope of that doctrine has contracted over the years. The federal government may tax interest on state and local obligations without running afoul of intergovernmental tax immunity or the 10th Amendment.[18] States may tax salaries and pensions of federal employees provided that they do not treat those employees more harshly than state employees.[19]

Unlike Germany and other countries that have a constitutional court with ultimate authority over interpretation of the national constitution,[20] the U.S. Constitution leaves its interpretation and application to the courts of general jurisdiction.[21] Review of statutes for consistency with the Constitution is not automatic[22] but requires a case or controversy to be presented to the courts.[23] The case may be an

[12] Cal. Const. Art. XIII A [tax limitation] (added June 6, 1978, by Prop. 13).

[13] Mo. Const. Art. X, section 18(e).

[14] 17 U.S. (4 Wheat.) 316 (1819). Compare the EU, where the central authority lacks the power to tax but the member states impose a contribution requirement for EU expenses on each member state. European Parliament, Fact Sheets on the European Union, General Tax Policy.

[15] Supreme Court and Court refer to the U.S. Supreme Court.

[16] U.S. Const. Art. I, section 8, cl. 18: "to make all Laws which shall be necessary and proper for carrying into execution the foregoing powers, and all other powers vested by this Constitution in the government of the United States, or in any department or officer thereof."

[17] *McCulloch*, 17 U.S. (4 Wheat.) 316, at 431.

[18] *South Carolina v. Baker*, 485 U.S. 505 (1988) (interest on unregistered bonds taxable).

[19] *Dawson v. Steager*, 586 U.S. ___ (2019) (citing *McCulloch* and its progeny, the Court confirmed that a state could tax federal employees on their pension payments from the United States but not more severely than it taxed state retirees on their state pensions. Discrimination by the state against federal employees was impermissible).

[20] Art. 100, Grundgesetz für die Bundesrepublik Deutschland (Basic Law of the Federal Republic of Germany) requires the courts to refer constitutional questions to the Bundesverfassungsgericht (Constitutional Court).

[21] *Marbury v. Madison*, 5 U.S. (1 Cranch) 137 (1803) (establishing the power of the federal courts to review statutes for conflict with the Constitution).

[22] Compare France, in which the Conseil Constitutionnel has the power to review legislation at enactment upon petition without prior litigation. F.L. Morton, "Judicial Review in France: A Comparative Analysis," 36 *Am. J. Comp. L.* 89 (1988).

[23] U.S. Const. Art. III, section 1, cl. 1.

action for a declaratory judgment in an appropriate instance.[24] With limited exceptions, the Supreme Court has discretion to accept or reject review, including review of constitutional issues, when litigants petition the Court for a writ of certiorari to review a lower court decision.[25] The courts, including the Supreme Court, generally are reticent on constitutional issues, and when possible, resolve their cases without interpreting the Constitution. The volume of constitutional decisions relative to cases resolved on other grounds tends to be lower in the United States than in countries that have a dedicated constitutional court and mandatory referral of constitutional questions.[26]

The Constitution limits the reach of state constitutions on matters reserved to the United States and, to a lesser degree, matters regarding which there is concurrent jurisdiction, like taxation.[27] If state law, including tax law, conflicts with the Constitution, the federal courts may strike down the state law, but do so reluctantly. Whenever possible federal courts defer to the decisions of state legislatures if the state law serves a rational, legitimate governmental purpose. If, however, a state law disproportionally disadvantages a suspect classification of individuals — people of color, for example — or undermines a taxpayer's fundamental rights like free exercise of religion, a federal court is likely to apply a more demanding review standard. The court may require the state to demonstrate that (1) the state has a compelling need for the law, and (2) the state cannot meet that need with a law that does not harm the suspect group or limit fundamental rights.[28] In *Harper*[29] a tax imperiled the taxpayer's fundamental right to vote. The state could not demonstrate a compelling need for payment of the tax to secure the right to vote so the Court intervened and struck it down.

Even arguments based on fundamental rights are often unsuccessful. For example, in *Nordlinger v. Hahn*[30] a taxpayer challenged Proposition 13[31] under the federal equal protection clause.[32] Equal protection is the United States' manifestation of the concept of equal rights. Equal protection does not demand precision in distribution of rights but requires only reasonable basis for laws that have disparate impacts on individuals or groups. If the law affects a suspect class of individuals adversely or limits a fundamental right, courts may apply heightened scrutiny. With property values increasing rapidly in California, a new resident is likely to pay a substantially higher property tax than a neighbor who has lived in their home for a long period, even though the homes are substantially identical. The taxpayer in *Nordlinger* argued that Proposition 13 led to substantial disparities in ad valorem real estate taxes between residences owned by long-term owners and new buyers, thereby infringing on her fundamental right to travel because the substantial increase in property taxes following her purchase of a residence impinges on her ability to relocate to California.[33] The Supreme Court rejected the right-to-travel claim because the taxpayer was living in a rented apartment in California already, and applied the minimal rational basis review standard. It held that the proposition did not violate equal protection

[24] *E.g.*, the recent decision in *South Dakota v. Wayfair*, 585 U.S. ___, 138 S. Ct. 2080 (2018), discussed *infra* in text accompanying note 42 was a declaratory judgment action brought by the state of South Dakota.

[25] Generally, on certiorari, see U.S. Courts, Supreme Court Procedures.

[26] Compare Germany, *supra* note 20. *See generally* Henry Ordower, "Horizontal and Vertical Equity in Taxation as Constitutional Principles: Germany and the United States Contrasted," 7 *Fla. Tax Rev.* 259 at 261-4 (2006) (hereinafter Ordower, "Horizontal and Vertical Equity"). For a broader collection of U.S. case law addressing the legislative power to tax, see Tracy A. Kaye and Stephen W. Mazza, "United States — National Report: Constitutional Limitations of the Legislative Power to Tax in the United States," 15 *Mich. St. J. of Int'l. L.* 481 (2007).

[27] *McCulloch*, 17 U.S. (4 Wheat.) 316 (prohibiting state taxation of a federal bank).

[28] This article refers to such review as heightened scrutiny.

[29] *Harper v. Virginia Board of Elections*, 383 U.S. 663 (1966), discussed *infra* note 37 and accompanying text.

[30] 505 U.S. 1 (1992).

[31] *Supra* note 12 and accompanying text.

[32] U.S. Const. Amend. XIV, section 1: "nor shall any State . . . deny to any person within its jurisdiction the equal protection of the laws."

[33] *Shapiro v. Thompson*, 394 U.S. 618 (1969) (holding a one-year waiting period to qualify for welfare benefits when moving to a new state unduly restricted the individual's right to travel and establish residence in a new location).

because the tax structure served the rational state interest of maintaining neighborhood stability.[34]

Overruling Precedent

Fundamental Rights: Poll Taxes and Voter Suppression

In *Breedlove*[35] the Supreme Court upheld a poll (capitation) tax applicable to all adult males but only to women who registered to vote. While the legislation did not expressly state that its goal was to suppress voting by people of color, the effect of the tax fell on the state's impoverished Black population and prevented many from exercising their voting rights. The Court concluded that even though the male taxpayers in *Breedlove* suffered discrimination based on their sex, adult men were not a disadvantaged and suspect class of litigants entitled to heightened scrutiny, so the state need only have a rational basis for the statute to withstand challenge under the equal protection clause.[36] The Court upheld the tax in *Breedlove* because it served the rational state purpose of raising revenue.

The Court overruled its *Breedlove* decision with *Harper*,[37] in which it applied the Constitution's equal protection clause to invalidate a poll tax. Failure to pay the poll tax barred the taxpayer from voting.[38] The Court concluded that voting — as a fundamental right — required heightened scrutiny in its review of the state tax, and held that voting rights must not depend on the voter's ability to pay the tax. Even acknowledging the equal protection violation, Justice Hugo Black dissented, confirming a commitment to the principle of *stare decisis* even in the face of historical error by arguing that the Court should follow its precedent because the Constitution had not changed.[39]

The victory for voting rights in *Harper* and the 24th Amendment proved pyrrhic. While taxes no longer played a role in voter suppression, gerrymandering of representative districts, voter identification laws, purging of voting rolls, and a variety of voter intimidation methods affect voting by people of color, especially in the southern United States.[40] The issue of the constitutional permissibility of partisan gerrymandering remains uncertain.[41]

State Borders and Use Taxes: Due Process and Commerce Clause Limitations

In 2018 the Supreme Court in *Wayfair*[42] decided that a state may require a vendor in another state and having no physical presence in the taxing state to collect use tax from buyers on items the vendor ships to them from outside their state of residence. The vendor must remit the collected tax to the buyer's state. The decision overruled two earlier precedents[43] as it addressed the authority of one state to reach across state lines to compel tax-related action in another state.

Most states impose a tax on the sale and delivery of goods in the state. The states collect the sales tax by requiring vendors in the state to collect the tax at the point of sale and remit the tax to the state. In instances in which the buyer is not a state resident and the seller ships the goods to the buyer at a location outside the state, the state generally does not impose its sales tax.[44] States imposing a sales tax also impose a

[34] *Nordlinger*, 505 U.S. 1 at 13-14. The Court noted that the new purchaser had no right to rely on the historical tax rate on property the individual wished to acquire. The economics are also uncertain. The market is likely to discount the value of a residence with low property taxes when the taxes will increase substantially after sale. The discount might be as great as the present value of the increased taxes for several years.

[35] *Breedlove v. Suttles*, 302 U.S. 277 (1937).

[36] U.S. Const. Amendment XIV, section 1.

[37] *Harper*, 383 U.S. 663.

[38] U.S. Const. Amend. XXIV, ratified in 1964, prohibits denial of franchise in any federal election because a voter fails to pay any tax. The amendment did not apply in *Harper* because the tax was imposed before the amendment, but its ratification may have influenced the court's decision.

[39] Of course, Black knew that the 24th Amendment would prevent future poll taxes.

[40] Vann R. Newkirk II, "Voter Suppression Is the New Old Normal," *The Atlantic*, Oct. 24, 2018.

[41] *Virginia House of Delegates v. Bethune-Hill*, No. 18-281, 580 U.S. ___ 137 S. Ct. 788 (2019)(dismissing appeal of lower court ruling finding gerrymandering unconstitutional).

[42] *Wayfair*, 585 U.S. ___, 138 S. Ct. 2080.

[43] *National Bellas Hess Inc. v. Department of Revenue of Illinois*, 386 U.S. 753 (1967); and *Quill Corp. v. North Dakota*, 504 U.S. 298 (1992).

[44] State requirements vary in instances in which the buyer is physically present but has the seller ship the goods to an out-of-state person who may be the buyer.

complementary use tax on goods shipped into the state for use there.[45] Collection of the use tax has been problematic. While the consumer of the goods has an obligation to pay the tax, many consumers do not pay voluntarily, and the state lacks the ability to identify all goods shipped to consumers in the state. Until *Wayfair*, states could not simplify use tax collection by imposing the burden to collect on vendors having no physical presence in the state, as earlier Supreme Court decisions determined.

When Illinois sought to compel out-of-state vendors to collect a use tax on sales of goods shipped to Illinois, a Missouri vendor with no physical presence but an active mail-order business in Illinois challenged the collection obligation. The Supreme Court held in *National Bellas Hess*[46] that under both the due process clause[47] and the commerce clause[48] of the Constitution, the vendor's lack of physical presence in the state precluded imposition of the collection obligation on the out-of-state vendor. Finding that the requirements of the due process and the commerce clauses were closely linked, the Court concluded that the tax collection obligation imposed a duty without the state having jurisdiction over the out-of-state vendor and interfered with interstate commerce. Power to regulate interstate commerce belongs exclusively to Congress.

Later, in *Quill*,[49] the Supreme Court abandoned due process as a barrier to imposing tax collection responsibility on an out-of-state vendor. The Court concluded that it would not be fundamentally unfair to an out-of-state vendor to carry tax collection responsibility. The Court discussed the development of due process thinking and decided that the out-of-state business availed itself of the markets in the state by soliciting business there. However, in the absence of physical presence in the state, the Court found that the tax collection obligation intruded on interstate commerce and, accordingly, violated the commerce clause. The Court concluded that regulation of interstate commerce belonged to Congress and Congress had the power to impose the tax collection responsibility on out-of-state vendors.

In *Wayfair*[50] the Court determined that it erred when it concluded that physical presence in the state was essential to the use tax collection obligation. Instead, only nexus with the state was required and the vendor's nexus was its use of various means to target sales efforts to and capture sales into the state by using the internet and other means of communication with state residents. The vendor was engaged in commerce in the state albeit without a physical presence. Requiring the vendor to collect and remit state taxes on goods it sold and shipped to customers in the state did not intrude on interstate commerce in violation of the commerce clause. The Court acknowledged that the state may regulate the impact of interstate commerce if it does not discriminate against out-of-state vendors[51] and has a rational basis for the regulation or tax in this case. The necessary rational basis is the loss of tax revenue on sales because consumers do not pay the use tax on out-of-state purchases they bring into or have delivered to them in the state, and there is no practical means to collect the use tax in most instances. Economic nexus suffices for a collection obligation considering the volume of commerce conducted over the internet, where concepts of physical presence are easily manipulated and avoided even in the presence of substantial activity over the internet into the taxing state.

Wayfair may be a sensible business decision for the digital age when physical presence is mutable, and frequently means little in terms of economic activity. Nevertheless, the decision is surprising insofar as the Court in *Quill* concluded that it need not address practical policy considerations concerning the digital application

[45] The combination of sales and use taxes produces revenue for the state and local governments. Unlike many countries, the United States does not have a centrally administered consumption tax like a VAT, revenue from which the central administrator might share with local governments.

[46] 386 U.S. 753.

[47] U.S. Const. Amend. XIV, section 1.

[48] U.S. Const. Art. I, section 8, cl. 3: Granting Congress the power "to regulate commerce with foreign nations, and among the several States."

[49] 504 U.S. 298.

[50] 585 U.S. ___, 138 S. Ct. 2080.

[51] *E.g.*, *Metropolitan Life Insurance Co. v. Ward*, 470 U.S. 869 (1985) (invalidating a gross premiums tax in Alabama that discriminated against out-of-state insurers).

of the commerce clause because Congress had the power to resolve the issue and authorize states to require out-of-state vendors to collect and remit use tax.[52] Despite Congress's failure to act, the Court chose to accept control over the matter as it applied a practical business standard to the limitations of the Constitution. The Court overruled its long-standing precedents.[53] The physical presence test permitted vendors to select their locations and structure their businesses to avoid the collection responsibility while enabling consumers to avoid state use taxes. With so much commerce using the internet, the physical presence test gave out-of-state vendors a material advantage over in-state vendors. Digital presence in a state sufficed to satisfy commerce clause limitations. Chief Justice John G. Roberts Jr., however, joined by three other justices, dissented, arguing that the Court should not overrule its commerce clause precedents even if incorrect. It is Congress's responsibility to evaluate the economic and policy impacts of a change in the rule. Failure of Congress to act when it has the power to act does not justify the Court's changing the outcome.[54]

Wayfair raises the question of whether a state might reach across an international border to compel a vendor to collect use tax on its behalf — an important question for sales of products, including online sales of purely digital products having no physical substance. Does international marketing or use of the international banking system for payment provide sufficient nexus to support imposition of a collection obligation on foreign vendors by local taxing authorities? If the answer is yes, will internet vendors eschew international banking in favor of cryptocurrencies to hide from taxing authorities? And how will states enforce that collection obligation? In domestic contexts, the federal and state courts are available to assist in collection because the decision is the law of the land. Courts in other countries, however, are free to reject the jurisdictional conclusions of the U.S. Supreme Court.

The Foreign Accounts Tax Compliance Act[55] demonstrates how one taxing authority might compel action across national borders where it otherwise lacks jurisdiction. Under FATCA the United States may disqualify foreign financial institutions from favored status under U.S. tax law. Foreign financial institutions often participate in reduced withholding opportunities on U.S. investments if they certify that their underlying investors meet the reduced withholding requirements. As a condition of participation in that program, FATCA requires the qualifying institutions to assist the United States in identifying U.S. taxpayers who invest in or through the foreign financial institutions.[56] Noncompliant institutions risk losing preferred reporting status regarding unrelated investments. Institutions in jurisdictions with financial secrecy protections have begun to reject investments from U.S. persons so they do not have to choose between financial secrecy and loss of preferred reporting status for their non-U.S. investors for whom the institution invests in the United States. It seems less likely that a state might have a comparable benefit to offer foreign vendors to induce use tax collection.

Borders and Taxing Jurisdiction

Wayfair[57] retreats from constitutional limitations on state cross-border taxing powers and, based on a broad open-ended nexus concept, substitutes jurisdiction to regulate sales activities of out-of-state vendors when the vendors enter in state markets. While permitting states to impose the obligation to collect the taxes from the vendors' customers, *Wayfair* does not empower states to impose taxes on the out-of-state vendors that have no physical presence in the taxing state. The Supreme Court confirmed the continuing vitality of the due process clause[58] as a limitation

[52] *Quill*, 504 U.S. at 318.

[53] *Wayfair*, 138 S. Ct. at 2080, 2097. The South Dakota Supreme Court had followed U.S. Supreme Court precedents and ruled against the state.

[54] *Id.* at 2101-2105 (Roberts, C.J., dissenting).

[55] P.L. 111-147, 124 Stat. 71 (2010).

[56] IRC section 1471 (requiring U.S. withholding agents to withhold 30 percent of payments made to foreign financial institutions that are not in compliance with FATCA reporting obligations).

[57] 585 U.S. ___, 138 S. Ct. 2080.

[58] U.S. Const. Amend. XIV, section 1.

on the state's power to tax out-of-state persons in *Kimberley Rice Kaestner 1992 Family Trust*.[59] In that case it held that a trust beneficiary's residence in a state did not provide a sufficient jurisdictional basis for taxing an out-of-state trust's income. The beneficiary received no income from the trust and had no power to require the trust to distribute income to the beneficiary.

Legislating Beyond Precedent

A few years after ratification of the 16th Amendment,[60] the Supreme Court invalidated a statute that included stock dividends in income for tax purposes. The Court held that a corporate dividend declared and paid in the issuing corporation's own shares was not income under the amendment.[61] The decision rested on the observation that after the dividend the shareholder had nothing more than or different from what the shareholder had before the dividend. The shareholder's proportional voting and participation rights remained unchanged. Unlike a cash distribution that increases the separate assets of the shareholder and decreases the assets of the corporation, a stock dividend changes nothing.

While the Court refined the limitations of the holding in subsequent cases[62] and expanded on the language in the decision that suggested income must come from capital or labor,[63] the Court has never overruled the decision. *Macomber* holds that, as a matter of constitutional law, separation of something from the capital or exchange of the property for cash or other property is a condition to inclusion in income.[64] Distribution of cash or property by the corporation other than additional shares of the same stock is income to the shareholder. A sale or other disposition of the corporate shares results in gain or loss includable in the income of the shareholder. Distribution of additional shares of stock is not income.

After *Macomber*, commentators characterized realization as an administrative rule of convenience rather than a constitutional requirement for inclusion of gain and recommended various permutations of taxation without realization.[65] Congress has enacted several statutes that include unrealized gain in income under specific circumstances to limit opportunities for tax avoidance. No taxpayer or interest group has launched a serious constitutional challenge to any of the statutes. Without a case or controversy, the Court has not confronted the constitutional question and the statutes remain in force.[66]

The first of the inclusions without realization was the foreign personal holding company rules.[67] Under those statutes, a U.S. person who was a shareholder in a closely held foreign corporation holding primarily passive investment assets[68] was taxable as if the corporation distributed its income as dividends.[69] The statute prevented individuals from using foreign corporations to defer inclusion in income of the return on their investments with an "incorporated (foreign) pocketbook." The

[59] *North Carolina Department of Revenue v. The Kimberly Rice Kaestner 1992 Family Trust*, 588 U.S. ___ (2019).

[60] U.S. Const. Amend. XVI.

[61] *Eisner v. Macomber*, 252 US 189 (1920). Shareholders own a greater number of shares than before the dividend, but their proportional interests are unchanged. The market value of a shareholder's total shareholdings may increase because of the stock dividend because the market may perceive the stock dividend as indicating that the corporation is doing well so that the share price rises. Alternatively, the market availability of a greater number of shares outstanding at a reduced dilution adjusted price per share increases demand for the shares at a lower price.

[62] *E.g.*, *Koshland v. Helvering*, 298 U.S. 441 (1936) (common share dividend with respect to preferred shares was taxable).

[63] *Commissioner v. Glenshaw Glass Co.*, 348 U.S. 426 (1955) (punitive damages are income).

[64] The exchange of property for cash or other property is referred to as realization, IRC section 1001(a). Gain or loss realized from the sale or exchange of property is recognized; that is, included in the taxpayer's income under IRC section 1001(c), unless another provision in the code permits the taxpayer to defer or exclude the recognized gain or loss. Many exceptions exist including IRC section 351, which permits transfer of property to a corporation in exchange for corporate shares.

[65] Stanley S. Surrey, "The Supreme Court and the Federal Income Tax: Some Implications of the Recent Decisions," 35 *Ill. L. Rev.* 779, 782-85 (1941) (administrative convenience). The literature favoring a shift away from realization-based taxation is extensive: David J. Shakow, "Taxation Without Realization: A Proposal for Accrual Taxation," 134 *U. Pa. L. Rev.* 1111 (1986); Jeff Strnad, "Periodicity and Accretion Taxation: Norms and Implementation," 99 *Yale L.J.* 1817 (1990); and Deborah H. Schenk, "An Efficiency Approach to Reforming a Realization-Based Tax," 57 *Tax L. Rev.* 503 (2004).

[66] *See* discussion of the case or controversy requirement, *supra* note 23 and accompanying text.

[67] IRC section 551 et seq. enacted 1937, repealed 2004.

[68] IRC section 553 (repealed).

[69] IRC section 551(b) (repealed).

personal holding company provisions that imposed a penalty tax on a U.S. incorporated pocketbook[70] did not violate *Macomber* because they taxed the corporation and did not impute a nonexistent dividend. A penalty tax could not apply to a foreign corporation because the United States did not have the power to tax a foreign corporation without a U.S. presence, but it did have the power to tax the corporation's U.S. owners. A single reported decision rejected a challenge to the foreign personal holding company tax on the shareholders but on grounds other than the imputed dividend, and relating to the shareholder's inability to use blocked currency in the United States.[71] When Congress later enacted another antiabuse structure for U.S. owners of a foreign corporation, Congress avoided imputing a nonexistent dividend and taxed the foreign corporation's income directly to the U.S. shareholders.[72] Disregarding the existence of the foreign corporation regarding income abusively directed to the foreign corporation was a more acceptable mechanism because it redirected income to its actual owner.[73]

Not until 1984 did Congress enact a statute requiring taxpayers to include in their incomes the appreciation or depreciation in the value of their property without realization.[74] The statute requires taxpayers to mark to market commodities and financial investment positions annually and include any change in the value during the year in income without an event of realization like a sale of the position. Industry participants offered no resistance to annual inclusion because they probably benefited from the statute.[75] Many industry participants did not hold the applicable positions for long periods. The statute defined includable gain from marking to market as 60 percent favored long-term capital gain usually requiring a one-year holding period and 40 percent short-term capital gain without regard to the taxpayer's actual holding period. There was no constitutional challenge to the statute.[76] The more recently enacted expatriation tax[77] uses the mark-to-market inclusion mechanism. The expatriation tax requires individuals who relinquish their U.S. citizenship or — if noncitizen residents, their right to reside in the United States — to mark all their property to market and include gain or loss in income when they expatriate. The tax is an antiabuse provision and has not been challenged constitutionally.[78]

The recently enacted transition tax[79] is not an antiabuse provision but facilitates the change to limited territoriality in U.S. taxation.[80] The tax is imposed one time and has stretched the limits of extranational taxation. It taxes earnings accumulated by a foreign corporation over several years to its U.S. shareholders[81] without the foreign corporation making any distributions or the U.S. shareholders taking any action regarding the accumulated foreign income. Like the shareholders receiving the stock dividend in *Macomber*,[82] the shareholders are taxed even though they have nothing different from what they had before the tax imposition and do not even receive a stock dividend. After the one-time tax, distributions out of foreign earnings of foreign corporations to their U.S. shareholders that are corporations are free from U.S. tax.[83] A constitutional challenge to the tax seems unlikely because the tax is imposed at a significantly reduced rate, can be spread over several years, and enables major corporations with foreign

[70] IRC section 541 et seq.

[71] *Eder v. Commissioner of Internal Revenue*, 138 F.2d 27 (2d Cir. 1943).

[72] IRC section 951 (taxing U.S. shareholders on some income of controlled foreign corporations) (enacted 1962).

[73] Compare IRC section 482 (power to reallocate income and deductions between taxpayers to clearly reflect income) and such cases as *Lucas v. Earl*, 281 U.S. 111 (1930) (income from services taxable to the individual who provided the services and earned the income).

[74] IRC section 1256 (enacted 1984).

[75] Ordower, "Revisiting Realization: Accretion Taxation, the Constitution, Macomber, and Mark to Market," 13 *Va. Tax Rev.* 1 (1993).

[76] IRC section 475 (requiring dealers in securities to mark their positions to market also drew no challenge because it included simplified opportunities to identify securities held for investment and exempt from marking to market).

[77] IRC section 877A (enacted 2010).

[78] Ordower, "The Expatriation Tax, Deferrals, Mark to Market, the *Macomber* Conundrumand Doubtful Constitutionality," 15 *Pitt. Tax Rev.* 1 (2017).

[79] IRC section 965 as added by the Tax Cuts and Jobs Act (P.L. 115-97).

[80] The United States taxes its citizens, residents, and domestic corporations on their worldwide income. IRC section 61; and reg. section 1.1-1(b).

[81] A U.S. shareholder is a term of art meaning a U.S. person owning 10 percent or more of the voting power or value of a foreign (non-U.S.) corporation.

[82] *Macomber*, 252 U.S. 189.

[83] IRC section 245A (100 percent dividends received deduction).

subsidiaries to repatriate foreign earnings at a low U.S. tax cost without restrictions on how the U.S. corporate shareholders use those repatriated earnings.[84]

Discussions in the media, among scholars, and in Congress regarding additional tax law changes recommend taking the United States still further from the realization limitations of *Macomber* and apportionment clause limitation.[85] For example, several members of Congress have proposed a wealth tax — seemingly at odds with the apportionment clause[86] and not a tax on income — applicable annually on the value of the individual's property. Proposals would exclude individuals with property valued at less than an asset threshold so that the tax would shift more of the overall tax burden to wealthy residents and U.S. citizens.[87] If enacted (and chances of enactment are low), the tax would be a direct tax on capital.

The Supreme Court held such a direct tax unconstitutional long ago,[88] but in this new era when constitutional limitations no longer seem a barrier, a wealth tax might not be challenged. Other proposals would expand annual marking to market to all securities and possibly other property.[89] Those proposals are consistent with unchallenged statutes already applicable to commodities[90] and at expatriation[91] even if their enactment seems contrary to *Macomber*.

Ignoring the Constitution

The preceding parts of this section suggest that the U.S. Constitution and possibly state constitutions play only a small role in constraining legislative action under the legislature's taxing authority. Constitutions primarily loom in the background, informing legislative reflection and possibly encouraging legislative restraint, but rarely becoming an impediment when the legislature chooses a course of action. Supreme Court decisions on tax matters provide some guidance to legislatures but it tends to be vague.

Discrimination in Taxation

While the Supreme Court has determined that a state may not tax an out-of-state business more than a comparable in-state business,[92] or a federal retiree less favorably than a state retiree,[93] the Court defers to the legislatures regarding the distributional characteristics of the tax structures if there is some rational basis for the tax.[94] The Court has not determined that the Constitution requires a taxing system to embed the equality-based principles of horizontal or vertical equity.[95] Seemingly like taxpayers need not be taxed alike if any rational governmental purpose for distinguishing them exists[96] and progressive taxation based on ability-to-pay principles may be appealing to scholars but is not constitutionally required.[97] Even the new 20 percent deduction for qualified business income is unlikely to be challenged successfully despite its classifications

[84] Ordower, "Abandoning Realization and the Transition Tax: Toward a Comprehensive Tax Base," 67 *Buffalo L. Rev.* 1371 (2019). *And see* Hank Adler and Lacy Willis, "The Worst Statutory Precedent in Over 100 Years," *Tax Notes*, Sept. 3, 2018, p. 1413; and Mark E. Berg and Fred Feingold, "The Deemed Repatriation Tax — A Bridge Too Far?" *Tax Notes*, Mar. 5, 2018, p. 1345, for arguments that the transition tax is unconstitutional because it is not apportioned as required by U.S. Const. Art. I, section 9, cl. 4. A constitutional challenge to the transition tax is pending in a district court but seems unlikely to succeed. *Moore v. United States*, No. 2:19-cv-01539 (W.D. Wash. 2020).

[85] U.S. Const. Art. I, section 9, cl. 4.

[86] *Id.*

[87] Neil Irwin, "Elizabeth Warren Wants a Wealth Tax. How Would That Even Work?" *The New York Times*, Feb. 18, 2019.

[88] *Pollock*, 157 U.S. 429.

[89] David Leonhardt, "A Man With a Plan for Inequality: Let the Rich Be Taxed the Way Everyone Else Is," *The New York Times*, Apr. 3, 2019. *See* Ordower, "Abandoning Realization," *supra* note 84.

[90] IRC section 1256.

[91] IRC section 877A.

[92] *Camps Newfound/Owatonna Inc. v. Town of Harrison*, 520 U.S. 564 (1997) (property tax exemption discriminating against out-of-state residents is impermissible).

[93] *Dawson*, 586 U.S. ___ (2019), text accompanying note 12.

[94] *Brushaber v. Union Pacific Railroad Co.*, 240 U.S. 1 (1916) (rejecting equal protection and due process challenges to a progressive income tax). In *Madden v. Kentucky*, 309 U.S. 83, 88 (1940), the Court stated: "The presumption of constitutionality can be overcome only by the most explicit demonstration that a classification is a hostile and oppressive discrimination against particular persons and classes."

[95] Compare the decision of the German Constitutional Court requiring horizontal equity in taxation but requiring only that "taxation of higher incomes be measured against taxation of lower incomes (vertical equity)." BVerfGE 107, 27, 46 (Dec. 4, 2002), translation and discussion from Ordower, "Horizontal and Vertical Equity," *supra* note 26, at 304.

[96] *Nordlinger*, 505 U.S. 1, and text accompanying note 29.

[97] Walter J. Blum and Harry Kalven Jr., "The Uneasy Case for Progressive Taxation," 19 *The U. Chi. L. Rev.* 417 (1952).

of taxpayers, favoring self-employed individuals over employees and disfavoring services performed in some professions.[98]

Scholars observe that the federal income tax discriminates racially in its delivery of the tax benefits associated with home ownership.[99] The bias in delivery of the tax benefits is not explicit in the statute. The statute allowing a deduction for mortgage interest, for example, is neutral and applies to all taxpayers.[100] It permits a deduction for residence interest when other personal interest is not deductible.[101] In addition to the mortgage interest deduction, the U.S. income tax does not include the use value of homes in the income of the homeowner and applies a favorable rate of taxation to gain on the sale of property. Both offer significant tax advantages to homeowners relative to renters.[102] Renters are taxable on the income they use to pay rent[103] but owners are not taxed on their use of their owned property. In effect owners pay for use of a residence with pretax dollars and renters with after-tax dollars. Yet, participation of people of color in the owned rather than rental housing market tends to be low nationally relative to white taxpayers.[104] Absent an express racial classification in allowance of tax benefits, the Constitution does not prevent the discriminatory impact of the tax law.

Church and State Separation

From its beginning as an independent nation, the United States required separation of church and state.[105] A governmental grant to a religious organization to enable it to build or improve a facility for a religious purpose may be impermissible and inconsistent with the establishment clause,[106] yet recently the Supreme Court held that a governmental agency may provide monetary assistance to a religious organization to improve a children's playground adjacent to a religious facility.[107] That decision may open the door to direct governmental payments to support religious functions or it may be an aberration because the playground improvement subsidy was designed for children's safety regardless of religious affiliation or promotion.

From the tax perspective, a legislative decision to provide a tax benefit to religious organizations is acceptable as long as the enabling statute does not discriminate by religious sect.[108] Accordingly, a tax exemption for a religious organization is permissible.[109] In fact, taxing religious institutions may be problematic. The state would have the power to destroy the institution if the state were to impose excessive and destructive taxation.[110] The exclusion from gross income of a housing allowance paid to "ministers of the gospel"[111]

[98] IRC section 199A, added by the TCJA, allows a deduction for qualified business income but excludes services performed as an employee and income from specified service businesses under section 199A(d). For commentary, see Edward Kleinbard, "Congress' Worst Tax Idea Ever," *The Hill*, Mar. 25, 2019.

[99] *E.g.*, Dorothy A. Brown, "Shades of the American Dream," 87 *Wash. U. L. Rev.* 329 (2010) (arguing implicit bias in delivery of tax benefits).

[100] IRC section 163(h)(2)(D) (deduction for qualified residence interest). The deduction is an itemized deduction that is less likely to offer a tax benefit after the TCJA because fewer taxpayers will itemize their deductions under the now larger standard deduction of IRC section 63.

[101] IRC section 163(h) (personal interest disallowed).

[102] Ordower, "Income Imputation: Toward Equal Treatment of Renters and Owners," in *Controversies in Tax Law: A Matter of Perspective* (2015).

[103] IRC section 262 (residential rent is a personal and family expense and not deductible).

[104] Jung Hyun Choi and Laurie Goodman, "What Explains the Homeownership Gap Between Black and White Young Adults?" Urban Institute (Nov. 20, 2018).

[105] U.S. Const. Amend. I reads in part: "Congress shall make no law respecting an establishment of religion, or prohibiting the free exercise thereof."

[106] *Everson v. Board of Education*, 330 U.S. 1 (1947) (stating that the state or federal government may not subsidize a religious facility but holding that the government may provide children transportation at government expense to religious schools as it provides transportation to public schools).

[107] *Trinity Lutheran Church of Columbia Inc. v. Comer*, 582 U.S. ___, 137 S. Ct. 2012 (2017).

[108] *Hernandez v. Commissioner*, 490 U.S. 680 (1989) (denying a deduction for Scientology auditing payments because the donor of the payments receives identifiable services in exchange, and adding that the charitable contribution deduction for contributions to religious organizations is long-standing and not an establishment clause violation).

[109] *Walz v. Tax Commission of City of New York*, 397 U.S. 664 (1970). Compare, *McCulloch*, 17 U.S. (4 Wheat.) 316, and accompanying text at note 10.

[110] *C.f. McCulloch* 17 U.S. (4 Wheat.) 316, and accompanying text at note 10.

[111] IRC section 107 (exclusion of lodging and an allowance for lodging used for that purpose). Ministers of the gospel is neutral and includes individuals serving ministerial functions in all religions.

withstood a challenge in the Seventh Circuit.[112] Other taxpayers who are not ministers paid by a religious organization may not exclude housing allowances and may exclude only lodging provided in kind for the employer's convenience and on their employer's premises.[113]

The Supreme Court has stated that the indirect subsidization of religious organizations through the charitable contribution deduction does not violate the establishment clause as long as the subsidy is equally available to all religions institutions.[114] Exempting a religious organization from tax, providing school transportation, and protecting children from injury on playgrounds are different from the government subsidizing donations to religious organizations. The charitable contribution deduction statute permits donors to direct part of the amount they otherwise would be obligated to pay in tax to the religious organization when they deduct the contributions they make to religious organizations.[115] The neutrality of the statute rather than its delivery of a subsidy is the focus of the Supreme Court's dictum. The effect of a charitable contribution deduction is a subsidy from the government to the religious institution equal to the tax benefit the donor derives from the contribution.[116]

Congress included the subsidy of the deduction in the tax law despite the constitutional limitation of the establishment clause. The Supreme Court extended permissibility of subsidies to religious education by ruling in *Espinoza v. Montana Department of Revenue*[117] that a state providing a tax credit benefit for private education must also include religious schools despite the Montana Supreme Court's ruling to the contrary. Commentators view the decision as far-reaching approval of government subsidies to religious schools that may threaten funding for public education by diverting governmental funds to private religious schools.[118]

State Constitutional Limitations on Taxes and Tax Increases

Several states have amended their constitutions to include tax limitations.[119] The limitations require an affirmative vote by the citizens before the governmental unit may increase a tax or enact a new tax. Both the state and its underlying municipal governments and agencies[120] have found it to be difficult to persuade voters to approve increases to provide the state or local government with the needed revenue to fund specified governmental services. In Missouri, the limitation includes governmental agency fees and taxes.[121] The constitutional provision prohibits tax increases without the vote but does not require a rebate of taxes collected in violation of the constitution[122] unless the state government collects excess revenues. The state must rebate excess state revenue through an income tax refund.[123]

Circumventing the constitutional limitation on taxes, municipal governments use their police power to produce revenue. The municipal executive provides the chief of police a revenue target and the chief of police instructs police officers to increase traffic and other offense

[112] *Gaylor v. Mnuchin*, 919 F.3d 420 (7th Cir. 2019). The court found a sufficient secular purpose in the exclusion despite its effect to support religion. The court identified three secular purposes for the legislation: "to eliminate discrimination against ministers, to eliminate discrimination between ministers, and to avoid excessive entanglement with religion." For the first purpose, only some ministers would fit the general exclusion under IRC section 119. Similarly, within the class of ministers, those receiving housing would exclude its value under section 119 while those receiving money would not.

[113] IRC section 119.

[114] *Hernandez*, 490 U.S. 680 (the statement is dictum and not a holding of the Court because there was no challenge to the deductibility of charitable contributions to churches).

[115] IRC section 170 (c) (allowing a deduction for contributions to some organizations, including religious organizations).

[116] *E.g.*, if a taxpayer whose income is subject to 20 percent tax makes a charitable contribution, the 20 percent tax on an equivalent amount of the taxpayer's income is redirected by the taxpayer to the donee. Of a $100 contribution the taxpayer provides $80 and the government $20. Details of the operation of the charitable contribution deduction are complicated by computational limitations in the IRC that are beyond the scope of this chapter.

[117] 591 U.S. ___ (2020).

[118] Adam Liptak, "Supreme Court Gives Religious Schools More Access to State Aid," *The New York Times*, June 30, 2020.

[119] *See* discussion, *supra* note 11 and accompanying and following text.

[120] Municipal governments and agencies are not wholly independent governmental agencies but derive their power from the state even if the state constitution or legislation grants them the power to act independently.

[121] Mo. Const. Art. X, section 18 (state); section 22 (local governments and agencies).

[122] Mo. Const. Art. X, section 23. *Zweig v. Metropolitan St. Louis Sewer District*, 412 S.W.3d 223, 251-252 (Mo. 2013).

[123] Mo. Const. Art. X, section 18(b).

citations to meet those revenue targets. Level of enforcement is flexible[124] so increasing enforcement is within police discretion. The municipal court imposes fines based on the citations and fees for use of the court and collateral functions of the court. The relationship between the offenses and punishment for the offenses loses significance relative to the revenue-producing function.[125]

The revenue produced by the fines and court fees are taxes, not punishments for traffic and other offenses,[126] because their primary function becomes revenue production rather than promotion of public safety or punishment of law violators.[127] As taxes they violate the state constitution because they were enacted under the police power rather than the taxing power of the state and voters did not approve them. Although there has been significant movement in scaling back the excessive use of fines in Missouri, no litigation has commenced to challenge the fines under the constitution's tax limitations.

Conclusion

The Constitution includes many protections for individual liberties and guarantees due process of law, equal protection, and separation of church and state. Where taxes are involved, the Constitution is rarely a barrier to legislative decision-making. The Supreme Court as arbiter of constitutional questions defers to legislative decisions regarding taxes if they have a rational state purpose and do not discriminate against out-of-state taxpayers. Regarding federal tax legislation, the Court similarly defers to Congress and has spoken to constitutional matters only on limited occasions. Even when the Court has spoken, the effect of its decision has retreated to insignificance except as background, informing but not controlling debate as to permissible changes in the tax laws. ■

[124] *E.g.*, an officer may issue a citation for any infraction of a speed limit but usually there is some tolerance for small infractions. The amount of tolerance is flexible.

[125] Henry Ordower, J.S. Onésimo Sandoval, and Kenneth Warren, "Out of Ferguson: Misdemeanors, Municipal Courts, Tax Distribution, and Constitutional Limitations," 61 *Howard L.J.* 113 (2017).

[126] *Id.* at 136-142.

[127] *C.f. National Federation of Independent Business v. Sebelius*, 567 U.S. 519 (2012) for an expansive definition of tax to include the shared responsibility payment under the Affordable Care Act (P.L. 111-148).